Jean-Claude Trichet: The financial crisis and the role of central banks – the experience of the ECB

Keynote address by Mr Jean-Claude Trichet, President of the European Central Bank, at the international symposium marking the 50th anniversary of Bank Al-Maghrib, Marrakech, 29 May 2009.

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Dear Governor Jouahri,
Dear Governors,
Ladies and gentlemen,

It is an honour and a great pleasure for me to be a speaker at this celebration marking the 50th anniversary of the Bank Al-Maghrib. I would like to congratulate Governor Jouahri on this occasion, and wish him and the staff of the central bank all the best for the future.

The Eurosystem has a well-established framework for dialogue with the Bank Al-Maghrib, the Euro-Mediterranean Seminar. This forum regularly brings together the governors of Eurosystem central banks with those of the "Barcelona Process: Union for the Mediterranean". The Euro-Mediterranean Seminar has, since its first meeting in 2004 in Naples, strengthened our dialogue by addressing various topics relevant to central banks around the Mediterranean. The Bank Al-Maghrib and Governor Jouahri have contributed to this fruitful exchange of views and will no doubt do so at the next meeting in March 2010 in Cyprus. In addition, the Bank Al-Maghrib has close bilateral relations with some of the central banks in the Eurosystem and in particular with the Banque de France on various aspects of technical assistance.

We are living in a very challenging time. Morocco, like all countries worldwide, has been hit by the global crisis. The business cycles of Morocco and the EU are largely synchronised and the existence of various economic transmission channels such as trade, tourism, and remittances, explain why both the European and Moroccan economies are going through a challenging period in the present global context.

My speech today will focus on the global financial crisis and its roots, on the ECB's response to the crisis and on the role of emerging market economies in the world economy.

The global financial crisis and its roots

Let me start by briefly highlighting the origins and evolution of the current crisis. Imagine a neutral observer who looked at the financial sector about a decade ago and then didn't look at it again until the eve of the current financial crisis. He would have found a completely different financial industry, one which over the past decade has undergone a dramatic shift of focus. He would have discovered a financial system that had moved away from its traditional role of supporting trade and real investment. He would have found a financial system in which speculation and financial gambling had run rife. He would have encountered a system transformed – a system no longer managing genuine economic risks but one actually creating and assuming financial risks – risks resulting from arbitrage and intentional exposure to asset price changes.

That same observer would have realised that financial liberalisation and innovation had made our economies more productive. The securitisation of assets, for example, had great potential to diversify economic risks and to manage them efficiently. But it also meant that financial institutions were able to sell loans or take them off the balance sheet, which weakened lenders' incentives to conduct prudent screening and constant monitoring of credit risk. So underwriting standards and lending oversight declined, and contributed to the excessive credit growth in the second half of the 1990s.

In sum, the observer would have concluded that the factors that fuelled the credit and asset price boom of the past decade also created the conditions for a bust.

In mid-2007 we started to see the backlash. The start of the financial turmoil was sudden but not unexpected. The financial system as it worked over the past decade – with its flawed incentives and its overly complex products and with global imbalances as its macroeconomic backdrop – was no longer sustainable. The asset cycle turned, the weaknesses were exposed and investors suddenly lost confidence. After years of exceptional risk appetite and high profits, the pendulum swung in the opposite direction, as markets became extremely sensitive to financial risk.

In September last year, the crisis escalated sharply. In particular, a major financial player collapsed, which was directly involved in about 30 large payment and settlement systems worldwide and had a balance sheet of USD 600 billion. Its failure turned a large-scale crisis of confidence into a global financial panic. Financial intermediaries restored liquidity buffers, tried to economise on capital and to scale down their balance sheets. They sold assets and tightened lending conditions. Banks and other financial institutions drastically reduced their exposure to the risks that they had imprudently accumulated during the phase of financial euphoria. Financial intermediation and loans to companies were curtailed in the wake of a forceful process of "deleveraging".

This was the point when important spillovers of the financial crisis set in. We saw the almost immediate spillover from the financial sector to the real economy. The credit squeeze and loss of confidence started to take a toll on the real economy, and a negative feedback loop developed between the financial sector and the real economy, and has since become a major feature of economic and financial developments. Almost simultaneously, the crisis that originated in the advanced economies spilled over to the emerging market economies. Since the fourth quarter of 2008, virtually all economies – both those of the industrialised countries and the emerging markets – have faced synchronised business cycles. Since half a year, we are facing a highly synchronised global economic downturn.

The ECB's response to the financial crisis

Turning to the ECB's response to the crisis, let me first insist that none of my remarks should be interpreted in terms of the future course of monetary policy. I stick rigorously to what I have said during my last press conference. We are indeed in the one-week "purdah period" before the next meeting of the Governing Council.

Since the start of the financial turmoil, central banks around the globe face unprecedented challenges. We at the ECB and other central banks have reacted swiftly, flexibly and decisively. The ECB took the lead with some exceptional decisions as early as 9 August 2007. We have, since then, modified our operational framework and used an exceptional set of non-standard policy tools. These tools, combined with the bold action taken by euro area governments over recent months, have played an essential role in preventing a collapse of the financial system and in bolstering confidence.

I would like to emphasise that despite this upheaval and our exceptional measures, our objective remains unchanged: to preserve price stability over the medium term, and that's what guides our policy. In so doing, we support the conditions for financial and economic stability. The crisis has not changed this objective.

Interest rates

As regards interest rates, the ECB's Governing Council has reacted promptly and decisively to the intensification and broadening of the global financial turbulence. We have lowered our key interest rate by 325 basis points since October 2008. This is the largest cut ever decided over such a short period in Europe. These moves were fully in line with our strategy. The upside risks to price stability have indeed receded considerably over that period due to the sharp fall in oil and other commodity prices, and the abrupt slowdown in economic activity. As price stability is the needle in our compass, we took account of the easing of inflationary pressures and lowered interest rates.

In this context, I would like to underline that since the introduction of the euro in 1999, the ECB's quantitative definition of price stability – an inflation rate of below, but close to, 2% in the euro area, over the medium term – has proved to be an invaluable asset. It has guarded against undesirably high inflation and against deflation. Long-term inflation expectations in the euro area, whether based on surveys or extracted from financial indicators, have been and continue to be firmly anchored at levels consistent with our definition of price stability. Inflation expectations have been exceptionally resistant to sudden upward short-term price changes, and we have ensured that is also the case with sharply falling inflation.

Non-standard measures

In addition to reducing interest rates, we have taken exceptional policy actions in response to the crisis – "non-standard" measures related to liquidity management. At the very start of the money market stress in August 2007, the ECB reacted within a few hours and temporarily provided additional liquidity to banks with immediate liquidity needs. We were in fact the first central bank to take non-standard measures.

When in mid-September 2008 the crisis intensified and interbank trading came to a virtual halt, the ECB engaged in a new mode of liquidity provision. We started to provide refinancing well above the levels that banks had absorbed to fulfil their reserve requirements in normal times. Our approach comprises three main "building blocks".

- We significantly adapted our regular refinancing operations. We now follow a "fixed rate full allotment" tender procedure and have significantly expanded the maturity of our operations. Banks have been granted access to essentially unlimited liquidity at our policy interest rate at maturities of, initially, up to six months. This is an exceptional mode of operation. In normal times we auction a given amount of central bank credit and let competition between the bidders determine the interest rate. This unusual mode of operation implies that we currently act as a surrogate for the market in terms of both liquidity allocation and price-setting.
- Our second building block is the long list of assets that we take as collateral. This list was already very long before the crisis, but we have extended it even further and now accept an even wider range of securities as collateral.
- The first two building blocks offer unlimited refinancing against a very wide range of collateral. But they can only reach the financial system if they are coupled with the third building block, namely the very large number of counterparties that have always been able to take part in our refinancing operations. Even before the financial crisis, this number was higher than for the other major central banks. Following the changes to our operational framework in October last year, this number rose further.

All these non-standard measures have now been supplemented by further exceptional steps that the ECB's Governing Council decided to take at its last meeting on 7 May.

- We will conduct liquidity-providing longer-term refinancing operations with a maturity of 12 months. This will further lengthen the maturity at which we provide banks with liquidity at fixed rates and full allotment. This move is consistent with the operations we have undertaken since October 2008 and it recognises the central role played by the banking system in the euro area economy.

- The European Investment Bank (EIB) will become an eligible counterparty in the Eurosystem's monetary policy operations. Access to the Eurosystem's liquidity is a natural complement to the EIB's financing initiatives and it will facilitate the accommodation by the EIB of additional demand for its lending programme.
- Furthermore, the Governing Council decided in principle that the Eurosystem will purchase euro-denominated covered bonds issued in the euro area. We expect to engage in a programme of around €60 billion that targets an important segment of the private securities market, which has been particularly affected by the financial market turbulence.

Our primary concern when taking these decisions in recent months was to maintain the availability of credit for households and companies at accessible rates. I have described that as "enhanced credit support". Furthermore, our very flexible liquidity management ensured that solvent banks did not get into difficulties because of liquidity constraints.

Our response to the crisis has been carefully calibrated to the financial and economic structures of the euro area. In particular, we needed to bear in mind that the euro area's financial system is predominantly bank-based. Take the structures of private credit outstanding as an example: recourse to banks makes up more than 70% of non-equity external finance in the euro area. By comparison, in the US the equivalent proportion is only around 30%. This reflects the fact that the US financial system is primarily market-based. In the euro area, guaranteeing steady access to credit for households and companies largely means preserving the viability of the banking system. Banks play such a dominant role in our economy that it was appropriate to focus our non-standard measures on the banking sector.

This profound contrast in financial and economic structures explains the different responses by central banks to the crisis as exemplified by the approaches of the ECB and the Federal Reserve System of the US. We rely on different channels as regards the transmission of our policy action. But these variations do not reflect conflicting views on fundamental principles or objectives. On the contrary: given the different structures, the approaches need to be different to achieve the same objective. Thus, I would strongly argue that central banks around the world are united in purpose.

As I indicated before, the remarks I just made on the ECB's response to the crisis did not contain any message concerning future monetary policy, and should not be interpreted as containing any such message.

Emerging markets and Mediterranean economies in the global economy

Today we are celebrating the 50th anniversary of Bank Al-Maghrib. This is also an occasion to reflect on the role of the Mediterranean region, and on the role of emerging market economies in general in the global economy.

The growing importance of these economies, including those in this area, has profound implications for the euro area and the rest of the world. I would like to share my thoughts with you on this phenomenon.

The growing role of emerging market economies

The global financial crisis is slowing the growth of the emerging market economies. Only a year ago, some observers were still saying that these economies were likely to decouple from the downturn stemming from the advanced economies. Today it is obvious that this has not happened. Most emerging markets are affected by the crisis through real or financial channels. Many sectors have been severely hit by the global turmoil, for instance, the automotive, textile, building and tourist industries. In addition, remittances which, for many emerging markets, are an important source of revenue, are vulnerable to the downturn in host countries, even though they tend to be a relatively stable source of income. It is too early to say when emerging market economies will bottom out of the global financial crisis, but some recent data, particularly for Asia, are somewhat encouraging. According to the latest IMF forecasts, world output will shrink by 1.3% and the advanced economies by no less than 3.8%. However, GDP in emerging markets, though lower than in previous years, will still grow by 1.6%.

Despite the crisis, the long-run prospects for emerging market economies remain bright. Projections for long-term growth, based on demographic trends and models of capital accumulation and productivity, suggest that the emerging markets are likely to gain in global importance. A number of studies found startling results regarding the growth prospects for emerging markets. According to one study, Brazil, Russia, India and China (the so-called BRIC economies) could account for over half the size of today's six largest industrialised economies from 2025 onwards.[1] We have to prepare for a very profound structural rebalancing of world output during the next years.

The world economy is changing profoundly, as so should its governance. The creation and the recent reinforcement of the G20 and the enlargement to the G20 of the Financial Stability Board are milestones in this respect. The rise of the emerging economies will also be reflected in the reforms of the international financial institutions.

What are the specific implications of the growing role of emerging markets for the euro area? The euro area has close links with emerging market economies. In trade terms, the euro area is actually more open than other major economies. Our exports and imports of goods and services account for more than 40% of GDP, significantly more than in the United States or in Japan. Emerging markets are important in trade: nine of 20 euro area's main trading partners are emerging economies, with a share of more than 18% of exports and around 31% of imports in 2008. The BRICs alone accounted for more than 12% of extra-euro area exports and more than 22% of extra-euro area imports in 2008.

The growing role of Mediterranean economies

In the present context, which is very challenging, the Mediterranean region is one of the few in the world that will continue to grow this year. The countries in this area have an increasingly important place among the world's emerging markets. Moreover, the Mediterranean economies, and particularly the Maghreb countries, have close links to the euro area. For example, more than 50% of Morocco's imports and exports are with the euro area.

Within the Mediterranean region, labour and product markets have become more flexible, the financial sector is now on a more solid footing and the economy has become more business-friendly. A continuation of these reforms will help to increase the long-run growth potential of the region. A continued implementation of such reforms would lay the foundation for an increase in the long-run growth potential in the region. Central banks and monetary policy frameworks are frontrunners in this reform process. In that respect, Morocco is an excellent example. Important progress has been made towards introducing an inflation targeting framework, which is the medium-term objective of Bank Al-Maghrib. The bank's new statutes promulgated in February 2006 confirmed its independence in the conduct of monetary policy and enshrined price stability as its primary objective mandate.

As you know, the Eurosystem attaches greatest importance to cooperating with central banks of emerging market economies, including those in the Mediterranean region. The ECB, as the central bank of the world's second largest integrated economy, very closely monitors economic developments in regions nearby, notably the Mediterranean.

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[1] See Wilson, D. and R. Purushothaman "Dreaming With BRICs: The Path to 2050", Global Economics Paper No. 99, Goldman Sachs, 1 October 2003.

As I said earlier, we have been working more closely in recent years by holding regular Euro-Mediterranean Seminars for central banks. And further east, we have established a similar seminar with the governors of the Gulf Cooperation Council. The group's first meeting was held in Germany last year.

Conclusion

To conclude, I would like to call your attention to the following points.

To start with, we are, for the first time, putting to the test the soundness and resilience of the globalised economy, which has become increasingly integrated over the past fifteen years. We now have to draw, systematically and without complacency, the lessons of the global crisis that we are fighting against.

Secondly, we have a duty. Our duty is to considerably reinforce the resilience of the global financial system and the soundness of the real global economy. We should not allow that, a few years from now, a new crisis would emerge that would be similar to the current one. That would be unforgivable.

Thirdly, the international community has engaged in drawing all lessons from the crisis. We agree on the method, on the role of the G20, on the role of the Financial Stability Board, and on the role of international financial institutions, in particular the crucial role of the International Monetary Fund, and also of the Bank for International Settlements, which during the past years has shown remarkable lucidity in its analysis. As regards the global financial sector, we agree on the broad orientations to follow: to reduce procyclicality, to fight short-termism, and to impose transparency.

Fourthly, we are still today in a very difficult and very unpredictable environment. We permanently need to remain alert, and there is no place for complacency. I would have two main messages in that regard. As concerns direct government support to the financial sector, today's priority is "rapidity of execution." Decisions that have already been taken should be implemented swiftly. This holds true, in particular, for recapitalisation, as currently only 55% of funds earmarked for recapitalisation have been used in the euro area. In crisis times, rapid implementation is crucial. As concerns global governance, I insist on the absolute necessity to reinforce macroeconomic policy surveillance of systematically important countries and economies. The IMF has to play a fundamental role in such monitoring, coupled with responsible and active peer surveillance.

Finally, central banks have a fundamental role in ensuring monetary and financial stability from a long-term perspective. Morocco knows that it can count on the crucial contribution of Bank Al-Maghrib, whose fiftieth anniversary we are celebrating today. The world economy can count on central banks to continue to act as anchors of stability, which are more needed than ever. The European Central Bank, for its part, will continue to be an anchor of stability and confidence. And I am pleased to note the recent proposals by the European Commission, in line with the recommendations of the de Larosière report, to establish a European Systemic Risk Council under the auspices of the ECB.

Thank you for your attention.